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**Beware the Vampires Among Us - Caution in the
Alternative Markets**

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LAST YEAR



THIS YEAR



WHY SHOULD YOU CARE ABOUT VAMPIRES?

Vampires are:

“beings who subsist by feeding on the life essence (generally in the form of blood) of living creatures”

Source: Wikipedia

HOW CAN YOU FIND THEM?

A few tips:

- Real vampires will always be able to find a shadow and will prefer to stand in the shadow as opposed to in the sun
- Real vampires tend to be very charismatic to some while having the complete opposite effect on other people.
- Real vampires tend to be extremely sensitive to sunlight and other bright lights, resulting in discomfort and most cases a migraine.

Source: <http://vampirewebsite.net/howdofindvampire.html>

WHAT DO VAMPIRES HAVE TO DO WITH PRIVATE EQUITY AND HEDGE FUNDS?

Vampire sponsors: GPs who will suck out your cash, give you nothing in return

Warning: Vampire sponsors thrive in the dark

- Returns presented to potential investors can be manipulated
- True story may not be known for years

A WARNING . . .

Treading into the private equity and hedge fund worlds requires vigilance:

- 1) Understand current dynamics
- 2) Look for signs of trouble before committing
- 3) Shine a light wherever you can

PRIVATE EQUITY – POST-FINANCIAL CRISIS

“Private equity shows surprising resilience”

“Kravis Says Markets Allow Cheapest Financing ‘Ever’ on Del Monte Takeover”

Covenant-lite loans/dividend re-caps are back!

Deal leverage increasing - up to 5.2x (4Q 2010) from 4x EBITDA in 2009

PRIVATE EQUITY TODAY– A SPONSOR’S VIEW

David Rubenstein, The Carlyle Group (SuperReturn Conference, 3/2011)

Known positives

- The economy has rebounded/unemployment has decreased; stock markets have improved
- Regulatory constraints are now largely known
- **Press attention has been elsewhere**
- Business communities are more accepting of private equity
- Investment pace is increasing and exit opportunities are better
- Limited partner distributions are coming back
- Fund-raising is picking up slightly and will probably rise
- **Relationships between general partners (buyout firms) and limited partners (investors in buyout funds) have improved since the financial crisis**

PE TODAY – A SPONSOR’S VIEW (CONT’D)

Known negatives (Rubenstein)

- **Price multiples are increasing**
- The general view of private equity is still sub-optimal
- First-time funds are becoming harder to raise
- Tax issues will continue to be debated

PE TODAY— A SPONSOR'S VIEW (CONT'D)

Known unknowns (Rubenstein)

- The impact of Middle East turmoil on valuations, opportunities in the emerging markets and oil prices
- The impact of US government resolution of budget and debt problems
- The ability of EU banks to deal with their debt problems
- The ability of the EU to support the euro in light of sovereign debt issues
- The impact of Middle East uncertainty on oil prices
- The effect of social networking on private equity
- The willingness of sovereign wealth funds and pension funds to remain committed to the private equity model

PE TODAY— A SPONSOR'S VIEW (CONT'D)

Greatest risks (Rubenstein)

- Believing another recession will be many years down the road and that it will be the same again
- Thinking that we dodged a bullet and that it is not returning
- Ignoring that there is a greater need to be ever transparent with government, the media and the public
- Ignoring the reality that general partners and limited partners are reliant on each other

OTHER SPONSOR COMMENTS

From SuperReturn survey of sponsors/investors/servicers:

“All private equity firms talk about adding value to their portfolio companies. Do you think it really happens?”

- | | |
|--|---------------|
| 1. With almost all investments: | 11.8 % |
| 2. Some of the time: | 73.6 % |
| 3. It is all marketing baloney: | 8.2 % |
| 4. On average they do the same as public companies | 6.4 % |

“It’s quite reassuring to see that level of support,” Jon Moulton, the chairman of Better Capital, the firm he founded after leaving the British private equity firm Alchemy, said of the survey. ***“I wouldn’t have been surprised to have seen quite a lot more voting for Nos. 3 and 4.”***

OTHER SPONSOR COMMENTS

From SuperReturn survey of sponsors/investors/servicers:

“Does private equity have an excess of funding over talent?”

Of those responding, 59.1 percent said yes, and 30.1 percent said no. Nearly 11 percent answered with the choice “Talent?”

PRIVATE EQUITY ENVIRONMENT - SUMMARY

Bullishness has returned (and perhaps excessive optimism)

New business risks – international turmoil, age of the internet, slow/no growth in traditional PE economies

And . . . many sponsors still dealing with overhang of 2005-2008 deals and the true results from those years may not be known for many years.

“The big test is how the investments made during the boom are going to play out and it’s too soon to tell,” Joe Dear, CALPERS chief investment officer, “If the capital structures in those deals hold together, the returns will be good and demand will be strong. If the economic scenario worsens, and the returns are poor, investors will turn away from private equity.”

PE SIGNS OF TROUBLE - SECONDARY SALES



PE SIGNS OF TROUBLE – SECONDARY SALES

Caution: sales between firms

“Where we tend to scratch our heads is where a company is passed between two large firms with similar characteristics and skill sets. . .You have to ask, what performance improvements will the new owners be able to make to the company that the previous owners already haven’t made?”

Margot Wirth, CALSTRS director of private equity investments

“We still have exposure to the company but at a higher valuation. To me this isn’t a sign of strength in the private equity business, but more a sign that firms must commit their capital before their investment period runs out.”

Joe Dear, CIO CALPERS

Stop: sales between funds of a single sponsor

PE SIGNS OF TROUBLE – MANAGEMENT TURNOVER IN PORTFOLIO COMPANIES

- Reflects lack of respect for what it takes to run a company
- Reflects a lack of understanding of how difficult it is to maintain sales, let alone achieve growth, in difficult economies

Note: CFO position is as important as CEO

PE SIGNS OF TROUBLE - DENIAL

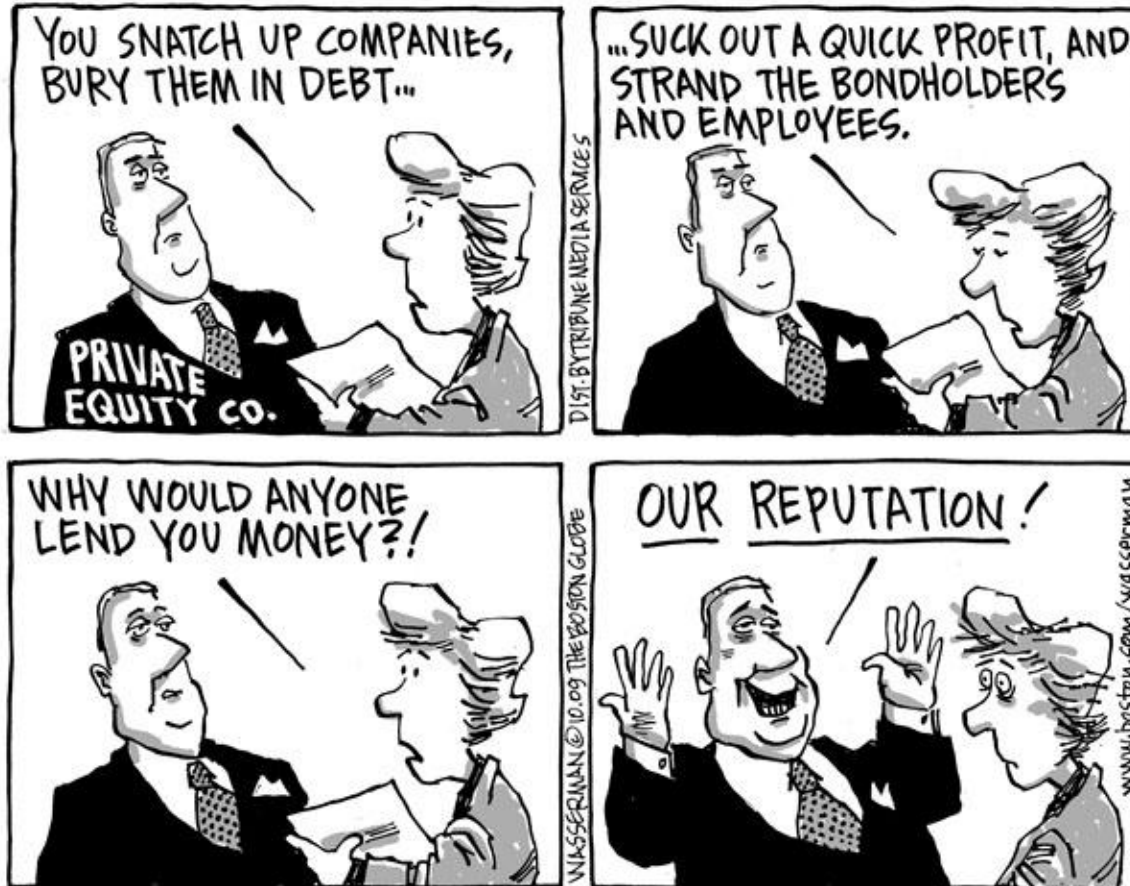
All experienced sponsors have bad deals:

- The good ones acknowledge them early and fix or get out
- The bad ones deny, extend/pretend ultimately destroying value, deluding investors about what their real returns will be

PE SIGNS OF TROUBLE: WRONG INVESTMENT THESIS

- Declining/changing industries like media
- Taking bets in regulated industries – HCA vs. TXU
- Flavor of the month (often not well understood): emerging markets
 - Rule of law
 - Different legal systems
 - Bribery
 - Home court advantage

PE SIGNS OF TROUBLE: FLIPPER MENTALITY



Squeezing companies for cash in short-term can create a mortal wound with investors accomplices in corporate homicide

PE SIGNS OF TROUBLE – LACK OF VISIBILITY INTO CURRENT FUNDS

- High unrealized profits
- High level of unfunded commitments

PE SIGNS OF TROUBLE – GP MAKES A LOT MORE MONEY THAN LPS

2009 Klausner and Klausner conference

[How will PE firms continue to make money just by] “flipping and flipping and flipping?”

Charlie Munger, Vice Chairman, Berkshire Hathaway

“They'll make it on fees, fees, fees.”

Warren Buffett, Chairman, Berkshire Hathaway

“... two thirds of the fee bill come from management fees and only a third comes from incentive fees.”

Phalippou/Gottschalg “The Performance of Private Equity Funds”

PE SIGNS OF TROUBLE – ASYMMETRICAL COMPENSATION

- Symmetry: Sponsor shares in realized rewards with investors with management fees covering all other sponsor operating costs
- Asymmetry: Sponsor paid from other sources – monitoring fees, advisory fees, arrangement fees, follow-on financing fees (from related fund)

HCA Returns: Bain investment ('06): **\$64MM**, returns from all sources through 3/11 IPO: **\$750MM**

LP investment ('06): **\$956MM**, returns from 3/11 IPO: **\$1B**

Source: NY Post

HEDGE FUNDS – POST-FINANCIAL CRISIS

Assets back up to \$2.5 trillion, below \$2.86 trillion in 2007 but above 2008 low of \$1.93 trillion . . .

Hedgefund.net

SEC scandals taking their toll

“Hedge fund managers are significantly more conservative than they were at the beginning of 2008, and I don’t think there are really the mega opportunities, like there were in subprime in ‘07 and ‘08.”

Virginia Parker, CIO Parker Global Strategies

HEDGE FUNDS – SIGNS OF TROUBLE

SEC queries:

"If I get even a whiff of an investigation, I want to get out before the next guy, especially if they have illiquid stuff or I don't know what they have" and "When the feds knock on your door, it's game over."

Anonymous hedge fund investors (Bloomberg)

HEDGE FUNDS – SIGNS OF TROUBLE

- **Side pockets**
- **Gates**

HEDGE FUNDS – SIGNS OF TROUBLE

- **Style drift**
- **Piggybacking**

HEDGE FUNDS – SIGNS OF TROUBLE

- Reporting past returns exclusive of side pockets
- Not fully disclosing incentive comp over down periods
 - Dangers of paying on unrealized returns whose valuation is often controlled by manager
 - Investor disadvantage due to lack of clawback

AVOIDING VAMPIRES IN ALTERNATIVES

- Stay away from sponsors who thrive in darkness
 - Require fully disclosed returns, including all assets
 - Require portfolio transparency
 - Welcome disclosure of mistakes
 - Demonstrate appropriate level of realized values for fund age and style
 - Have external audits performed by known, knowledgeable auditor
- Stay away from sponsors whose only mission is to get your life blood; pick those who:
 - Are oriented towards building long-term relationships with investors, building value
 - Avoid trends/fads that they don't understand or over which they have minimal control
 - Have clear, competitive strategy for how they will make you money in challenged economic times
- Look for sponsors who don't suck all the returns out for themselves
 - Share all fees with investors; require that most fees be earned as incentive comp for success
 - Enforce claw-backs
 - Reduce non-success related fees
 - Use objective, third party valuation

FURTHER QUESTIONS?

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